

IT 99-17

Tax Type: Income Tax

Issue: Apportionment: One Factor/Three Factor Application Issues

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS**

v.

**"Rarified Chemical Company",
Taxpayer**

**No. 93-IT-0000
FEIN: 36-0000000
Tax yr.: 12/89 through 12/91**

**Charles E. McClellan
Administrative Law Judge**

RECOMMENDATION FOR DECISION

Kathryn H. Michaelis for the Department of Revenue. Robert Denvir and Alan Lindquist of Winston & Strawn for the Taxpayer.

Synopsis:

This matter involves a Notice of Deficiency ("NOD") issued by the Department to "Rarified Chemical Company" ("Rarified Chemical") on August 6, 1993 for the years 1989 through 1991¹. Taxpayer timely filed a protest on October 7, 1993.

Originally, there were three unresolved issues, including an issue regarding the addition of foreign dividends to the numerator and denominator of "Rarified Chemical's" combined sales factor for the years at issue. The parties filed cross motions for summary judgment on that issue and oral argument was heard. On November 24, 1997, an Order and Memorandum Decision was entered granting the taxpayer's motion for summary judgment, to exclude the foreign dividends

¹ Taxpayer files its income tax returns on a calendar year basis.

from the numerator and denominator of the combined sales factor and denying the Department's motion.

The remaining issues are:

- a. Whether interest income received by "Rarified Maryland Company" in 1991 from promissory notes issued to foreign affiliates should be included in the numerator of "Rarified Chemical's" combined Illinois sales factor for the tax year 1991; and
- b. Whether "Rarified Chemical" is entitled to abatement of penalties imposed pursuant to Section 1005 of the IITA, 35 ILCS 5/1005, for the tax years at issue.

An evidentiary hearing was set for March 17, 1999. At the hearing the parties filed a stipulation of facts and presented oral arguments. After the hearing, "Rarified Chemical" filed a post-hearing brief, the Department filed a response and the "Rarified Chemical" filed a reply.

I recommend that the Notice of Deficiency be recalculated as follows:

1. To take into account the order entered on November 27, 1997 (to exclude foreign dividends from the sales factor),
2. To include the interest income at issue in the numerator of the combined sales factor,
3. That the Section 1005 penalty be abated.

Finding of Facts:

1. "Rarified Chemical" timely filed Illinois income tax Forms IL-1120 for the years 1989 through 1991 on a combined unitary basis with various subsidiaries, including "Rarified Maryland Company". Stip. ¶ 1.

2. The Department conducted an audit of "Rarified Chemical's" Illinois income tax returns for the years 1989 through 1991, at the conclusion of which it proposed several adjustments, including the following:

- (a) the addition of foreign dividends to the numerator and denominator of "Rarified Chemical's" combined sales factor for the years at issue;
- (b) the addition of interest income earned on intercompany loans to the numerator of "Rarified Chemical's" combined sales factor for the tax year 1991;
- (c) the imposition of penalties pursuant to Section 1005 of the Illinois Income Tax Act, 35 ILCS 5/1005, for the years at issue. Stip. ¶ 2.

3. A timely Notice of Deficiency was issued on August 6, 1993 to "Rarified Chemical" for the years 1989, 1990 and 1991 in the amount of \$570,449. Stip. ¶ 3.

4. The proposed assessment of \$570,449, consisted of tax and penalty as follows:

Tax Year	Tax	Penalty
1989	\$80,348	\$15,428
1990	\$166,534	\$23,700
1991	\$263,217	\$21,222
Total	\$510,099	\$60,350

Stip. ¶ 4.

5. "Rarified Chemical" timely filed a protest on October 7, 1993, objecting to the Department's proposed adjustments. Stip. ¶ 5.

6. On November 24, 1997, an Order and Memorandum Decision was entered excluding the foreign dividends from the numerator and denominator of the sales factor. Stip. ¶ 6.

7. Based upon the November 24, 1997 order, the revised tax deficiencies, exclusive of interest and penalties, that remain at issue in the administrative hearing are as follows:

Tax Year	Tax Deficiency
1989	\$1,579
1990	\$9,510
1991	\$101,894
Total	\$112,983

Stip. ¶ 7.

8. "Rarified Chemical" continues to protest the remaining issues that are the subject of the administrative hearing:

- a. Whether interest income received by "Rarified Maryland Company" ("Rarified Maryland") in 1991 from promissory notes issued to foreign affiliates should be included in the numerator of "Rarified Chemical's" combined Illinois sales factor for the tax year 1991; and
- b. Whether "Rarified Chemical" is entitled to abatement of penalties imposed pursuant to Section 1005 of the IITA, 35 ILCS 5/1005, for the ax years at issue. Stip. ¶ 8.

9. "Rarified Chemical" was incorporated under the laws of "Maryland" in 19xx. Stip. ¶ 9.

10. During the years at issue, "Rarified Chemical" was headquartered at "Five Two One Capital Square" in "Someplace", Illinois. Stip. ¶ 10.

11. During the years at issue, "Rarified Chemical" filed its Illinois income tax returns, Forms IL-1120, on a combined, unitary basis with several subsidiaries, including "Rarified Maryland". Stip. ¶ 11.

12. "Rarified Chemical" was primarily engaged as a producer of specialty chemicals and services for water and waste treatment, pollution control, petroleum production and refining, papermaking, mining, steelmaking, metalworking, and other industrial processes. Stip. ¶ 12.

13. "Rarified Maryland" was a 100% owned, unitary subsidiary of "Rarified Chemical". Stip. ¶ 13.

14. "Rarified Maryland" was incorporated on March 7, 1991, under the laws of the state of "Maryland". Stip. ¶ 14.

15. "Rarified Maryland" was created because a "Maryland" subsidiary could generate certain federal tax benefits by lending money to the foreign subsidiaries of "Rarified Chemical", benefits to which "Rarified Chemical" would not have been entitled if it had lent the money directly to the foreign subsidiary companies. Stip. ¶ 42.

16. "Rarified Maryland" was created by capital contributions from "Rarified Chemical" in March of 1991 in the amounts of: \$1,000, \$621,347.65, and \$141,005,000. Stip. ¶ 15.

17. In 1991, "Rarified Maryland" was located and maintained its only office at 1111 West Interpol Street, Suite 0000, "Somewhere, "Maryland". Stip. ¶ 16.

18. In 1991, "Rarified Maryland" did not maintain an office in Illinois. Stip. ¶ 17.

19. In 1991, "Rarified Maryland" did not have any employees located in Illinois (other than corporate officers). Stip. ¶¶ 18, 22, 25.

20. In 1991, "Rarified Maryland" did not maintain any tangible or real property in Illinois. Stip. ¶ 19.

21. A special organizational meeting of the board of directors, and the only board of directors meeting held in 1991, was held in "Someplace", Illinois on March 14, 1991. Stip. ¶ 20.

22. On May 29, 1991, "Rarified Maryland"'s board of directors, by Consent in Lieu of Board of Directors Meeting, declared dividends payable to "Rarified Chemical" on May 29, 1991, of \$1.5 million and on November 22, 1991 of \$3.985 million. Stip. ¶ 21.

23. The officers of "Rarified Maryland" and their respective positions with both "Rarified Chemical" and "Rarified Maryland" in 1991 were as follows:

Name	Position with "Rarified Chemical"	Position with "Rarified Maryland"
"John Doe"	Senior Vice-President & Chief Financial Officer	Chairman and President
"Richard Roe"	Vice-President, Secretary & General Counsel	Vice President
"Joe Doakes"	Assistant Secretary	Secretary
"David Schwartz"	Treasurer	Treasurer
"Adam Ant"		Assistant Treasurer
"Sam Sung"	Assistant Treasurer	Assistant Treasurer
"Tom Wade"		Assistant Secretary

Stip. ¶ 22.

24. The directors of "Rarified Maryland" were: "John Doe", "David Schwartz", and "Tom Wade. Stip. ¶ 23.

25. All of the officers listed in Paragraph 22 were located at "Rarified Chemical"'s offices in "Someplace", Illinois, with the exception of "Tom Wade", the Assistant Secretary for "Rarified Maryland", who also was an officer of "Somewhere" Trust Company, and whose office was located in "Somewhere, Maryland". Stip. ¶¶ 24, 81.

26. "Joe Doakes", "Rarified Maryland's Assistant Secretary, prepared the minutes of "Rarified Maryland's Board of Directors meetings. Stip. ¶ 25.

27. "David Schwartz", "Rarified Maryland's Treasurer, exercised control over all cash management decisions for "Rarified Maryland". Stip. ¶ 26.

28. "Rarified Maryland's Illinois and federal income tax returns were prepared in "Someplace", Illinois. Stip. ¶ 27.

29. "Rarified Maryland's" "Maryland" franchise, information, and payroll tax returns were prepared by "Maryland" Corporate Management in "Somewhere, Maryland". *Id.*

30. "Rarified Maryland" paid dividends to "Rarified Chemical" in 1991 as follows: \$1.5 million on May 30, 1991; and \$3.985 million on November 25, 1991. Stip. ¶ 28.

31. "Rarified Maryland's" assets consisted of cash; notes receivable (from "Rarified Walkabout Pty. Ltd". and "Rarified English Investments, Ltd". (a/k/a "Goaltender" Ltd.); and accrued interest receivable on the aforementioned notes. "Rarified Maryland's" liabilities included employee compensation and tax accruals. Stip. ¶ 32.

32. The sole source of income for "Rarified Maryland" during March through December of 1991 was interest income from promissory notes issued by two of "Rarified Chemical's" foreign subsidiaries to "Rarified Maryland". The two foreign subsidiaries were "Goaltender Ltd." (later renamed as "Rarified English Investments, Ltd.") in England and "Rarified Walkabout Pty. Ltd.", in Australia. Stip. ¶ 35.

33. The principal amount of funds loaned by "Rarified Maryland" to each Foreign Subsidiary in 1991 was as follows:

Loans to "Rarified English Invest." (in U.K. pound sterling)	Date	Principal
Loan No. 1	3/20/91	21,535,422
Loan No. 2	3/20/91	10,000,000
Loan No. 3	3/20/91	5,000,000
Loan No. 4	3/20/91	5,000,000
Loans to "Rarified Walkabout Pty Ltd. "(in Australian currency)		
Loan No. 1	3/20/91	87,633,221
Loan No. 2	3/12/91	811,000

Stip. ¶ 36.

34. During 1991, "Goaltender Ltd." (a/k/a "Rarified English Investments, Ltd.") and "Rarified Walkabout Pty. Ltd.", made interest payments, as required by the promissory notes as follows:

"Rarified English Investments".	\$6,356,702
"Rarified Walkabout Pty Ltd.:	<u>\$7,554,441</u>
Total	\$13,911,143

Stip. ¶¶ 37, 39.

35. On its 1991 IL-1120, "Rarified Chemical" reported the interest income received by "Rarified Maryland" from the foreign subsidiaries as part of combined business income and as part of the denominator of the combined Illinois sales factor, but not as part of the numerator of the combined Illinois sales factor. Stip. ¶ 40.

36. The purpose of the promissory notes was to enable "Rarified Maryland" to loan funds to the foreign subsidiaries, which would enable "Rarified Chemical", through the foreign subsidiaries, to acquire shares of two of "Rarified Chemical's affiliates, "Cacciatore Ltd". in Australia and "Knoxblox Ltd" in the U.K., from "Arbitrary Chemical Productions, P.L.C". (or one of its subsidiaries). Stip. ¶ 41.

37. "Cacciatore" and "Knoxblox, Limited" provided "Rarified Chemical's water treatment and specialty process chemicals to customers, and their operations were consolidated effective April 1991. *Id.*

38. The funds loaned by "Rarified Maryland" to the foreign subsidiaries through the promissory notes were funds obtained from the capital contributions made by "Rarified Chemical" to "Rarified Maryland" in March of 1991. Stip. ¶ 43.

39. On August 22, 1991, "Rarified Chemical's Board of Directors passed a resolution that authorized "Rarified Chemical" to support: (a) interest rate and foreign exchange rate

protection agreements that "Rarified Maryland" entered into to protect its loans to "Rarified Walkabout" and "Rarified English Investments" and (b) interest rate and foreign exchange rate agreements entered into by other "Rarified Chemical" subsidiaries. Stip 45.

40. With the authorization of "Rarified Chemical's" Board of Directors, "Rarified Maryland" entered into interest rate and foreign exchange rate protection agreements with Bankers Trust to protect its loans to the foreign subsidiaries from interest and currency exchange rate fluctuations. Stip. ¶¶ 44, 45.

41. The signatories on the Promissory Note to "Rarified English Investments, Ltd." were: (1) "David Schwartz", Treasurer of both "Rarified Chemical" and "Rarified Maryland"; (2) "Fred Dwyer", Senior Vice-President and Chief Financial Officer of "Rarified Chemical", and Chairman and President of "Rarified Maryland"; and (3) "Peter Peachfuzz" of "Rarified English Investments, Ltd." Stip. ¶ 46.

42. Mr. "Schwartz" and Mr. "Dwyer" reviewed and signed the Promissory Note in Illinois. Mr. "Peachfuzz" signed the Promissory Note in Europe. *Id.*

43. "David Schwartz" reviewed the Promissory Note between "Rarified Maryland" and "Rarified Walkabout Pty Ltd." in Illinois prior to its execution. Stip. ¶ 47

44. "Rarified Chemical's" Legal Department drafted and reviewed the promissory notes in Illinois. Stip. ¶ 48.

45. "Rarified Maryland's" Board of Directors, by resolution, authorized loans to be made to the foreign subsidiaries at its meeting at "Rarified Chemical's" headquarters in "Someplace", Illinois on March 14, 1991. Stip. ¶ 49.

46. Board Resolutions of "Rarified Maryland" were drafted by "Rarified Chemical's" Treasury/Legal Department in "Someplace", Illinois, and submitted to the "Rarified Maryland" Board of Directors. Stip. ¶ 50.

47. "Sam Sung" and "David Schwartz" were in communication with "Rarified English Investments, Ltd." and/or "Rarified Walkabout Pty Ltd." from their offices at "Rarified Chemical" in "Someplace", Illinois, regarding the promissory notes, specifically relating to each company's cash flow requirements for purchasing the shares and any other expenses or working capital requirements. Stip. ¶ 51.

48. Any cash received by "Rarified Maryland", including interest income from the promissory notes, was held no longer than overnight before being remitted to "Rarified Chemical's" corporate bank account in "Someplace", Illinois. Stip. ¶ 52.

49. Copies of the promissory notes between "Rarified Maryland" and the foreign subsidiaries were maintained in "Rarified Chemical's" Treasury Department in "Someplace", Illinois. Stip. ¶ 53.

50. On March 14, 1991, the board of directors of "Rarified Maryland", by resolution, authorized the "Fictional Guaranty Trust Company of New York" to accept deposits in the name of "Rarified Maryland". Stip. ¶ 50.

51. The authorized signature authorities for "Rarified Maryland's" bank account with the "Fictional Guaranty Trust Company of New York" are "David Schwartz", Treasurer; "Sam Sung", Assistant Treasurer; and "Adam Ant", Assistant Treasurer. Stip ¶ 55.

52. On March 15, 1991, "Rarified Maryland" entered into an agreement with "Somewhere" Trust Company engaging "Somewhere" Trust Company to act as custodian of such property as might be delivered to it. Stip. ¶ 56.

53. "Rarified Maryland" maintained two accounts at "Somewhere" Trust Company, specifically: (a) a custody account, No. 28702-0; and (b) a demand deposit account, No. 2516-5292. Stip. ¶ 57.

54. The \$3,986,687.03 receipt by "Rarified Maryland" into Account No. 28702-0 on November 25, 1991 represented a payment from "Fakery" Trust New York on the interest rate and currency swap protecting the Promissory Note between "Rarified Maryland" and "Rarified English Investments, Ltd." Stip. ¶ 59.

55. These receipts were recognized and recorded by "Rarified Maryland" as interest income. *Id.*

56. "Accountants R. Us" ("ARU") was engaged in the business of providing office, accounting, and clerical services to companies. Stip. ¶ 61.

57. During 1991, "ARU" provided office and clerical services to "Rarified Maryland". Stip. ¶ 62.

58. During 1991, "ARU" was located at "1111 West Interpol Street, Suite 0001, in "Somewhere, Maryland" ("Suite 0001"). Prior to October of 1990, "ARU's" office was located at "666 Armageddon Road, Suite 111, in Somewhere, Maryland". Stip. ¶ 63.

59. "Rarified Maryland" paid a fee to "ARU" for services and use of office facilities at "1111 West Interpol Street, Suite 0001", in "Someplace, Maryland" as reflected in the "ARU" Service Agreement between "Rarified Maryland" and "ARU". Stip. ¶ 64.

60. The service agreement between "ARU" and "Rarified Maryland" specified fees according to a fee schedule under the terms of which "Rarified Maryland" paid an initial fee of \$500, an annual fee of \$3,000 for administration, shared office services and salary for an employee;

in addition it provided for "Rarified Maryland" to pay an annual fee for accounting services on an hourly basis with a minimum fee of \$1,000. *Id.*, Ex. No. 24.

61. "Rarified Maryland" did not rent specific office space, but had a shared rental arrangement for use of the Suite 0001 office facilities. Stip. ¶ 65

62. "Rarified Maryland" paid a fee to "ARU" for services and the use of Suite 0001 for the months of October, November and December of 1991 in the amount of \$450. Stip. ¶ 66.

63. "Rarified Maryland" had no employees, other than employees retained through "ARU". Stip. ¶ 67.

64. The "ARU" Service Agreement was executed in "Someplace", Illinois. Stip. ¶ 68.

65. "Boris Badenov", "David Schwartz", "Fred Dwyer", "George Priester", and "Joe Doakes", all employees of "Rarified Chemical", reviewed the "ARU" Service Agreement in "Someplace", Illinois, prior to its execution. Stip. ¶ 69.

66. During 1991, "Edward Everett Horton" was employed by "ARU" as its President. Stip. 70.

67. "Edward Everett Horton" was also employed by several companies who were clients of "ARU" but not members of the "Rarified Chemical" unitary group. Stip. ¶ 71.

68. "Rarified Maryland" was also one of "ARU's" clients in 1991. Stip. ¶ 72.

69. "Rarified Maryland" paid Mr. "Horton's" salary of \$300 per month for the months of October, November and December of 1991. Stip. ¶¶ 66, 74, Stip Ex. No. 13.

70. No other "ARU" employees were employees of "Rarified Maryland". Stip. ¶ 75.

71. Mr. "Horton" received a W-2 from "Rarified Maryland" for 1991. Stip. ¶ 76.

72. Mr. "Horton" performed services for "Rarified Maryland" from Suite 0001 location in "Somewhere, Maryland" but not from any other location. Stip. ¶ 77.

73. Mr. "Horton's" responsibilities for "Rarified Maryland" were to ensure that the following services were provided for "Rarified Maryland" by "ARU" employees: answering of telephone calls for "Rarified Maryland"; payment of bills; preparation of quarterly payroll tax returns for Mr. "Horton"; preparation of a W-2 for Mr. "Horton"; processing and acting upon mail addressed to "Rarified Maryland" at Suite 0001; reconciling the checking account on a monthly basis; and reviewing the monthly custody account at "Somewhere" Trust Company. Stip. ¶ 78

74. Mr. "Horton" had no contact with any individuals at "Rarified English Investments, Ltd." nor "Rarified Walkabout Ltd." Stip. ¶ 79.

75. Mr. "Horton" was not responsible for reviewing or enforcing the promissory notes. Stip. ¶ 80.

76. Mr. "Horton" had contact with only one individual from "Rarified Maryland", namely, "Tom Wade", "Rarified Maryland"'s Assistant Secretary, who was also an officer of "Somewhere" Trust Company located in "Somewhere, Maryland". Stip. ¶ 81.

77. Mr. "Horton" was in contact with Mr. "Wade" approximately twice during 1991. *Id.*

78. During 1991, Mr. "Horton" was in contact twice with Mr. "Wade" at "Somewhere" Trust Company regarding "Rarified Maryland". Stip. ¶ 81.

Conclusions of Law:

Sales Factor Issue

The first issue in this case involves the statutory apportionment formula that applies to corporations that operate in Illinois and other states. If a corporation does business in Illinois and one or more other states, the Illinois statute requires the application of a three factor formula to apportion the corporation's business income to Illinois. General Telephone Co. v. Johnson, 103 Ill.2d 363, 83 Ill.Dec. 133, 469 N.E.2d 1067, (1984). The apportionment formula is set forth in

Section 304(a) of the Act.² The Illinois Supreme Court, in General Telephone Co. v. Johnson, described the operation of section 304(a)'s three-factor formula in the following terms:

"The formula-apportionment method prescribed by section 304(a) first requires that the taxpayer compute three factors, which are based on his property, payroll, and sales. The property factor is a fraction whose numerator is the taxpayer's Illinois property, and whose denominator is all of the taxpayer's property. The payroll and sales factors are computed similarly (i.e., Illinois payroll/all payroll; Illinois sales/all sales). Section 304(a) then requires the taxpayer to average the three factors, with the resulting fraction being the taxpayer's 'apportionment factor.' The section 304(a) apportionment factor is the percentage of the taxpayer's business income that will be taxed in Illinois." 103 Ill.2d at 370, 83 Ill.Dec. at 136, 469 N.E.2d at 1070.

On September 14, 1986, section 304(a) was amended by P.A. 84-1382 to double weight the sales factor. Other than that, the formula that applies to the years at issue is the same as described by the court in General Telephone Co. v. Johnson, *supra*.

The issue involved in this case is whether interest income received by "Rarified Maryland" in 1991 from promissory notes issued to foreign affiliates should be included in the numerator of "Rarified Chemical's" combined Illinois sales factor for the tax year 1991. (The interest in question was included in the combined sales tax denominator in the apportionment formula reported by "Rarified Chemical", but not in the numerator.)

"Rarified Maryland" is a corporation formed by "Rarified Chemical" for the purpose of loaning money to two of "Rarified Chemical's" foreign subsidiaries so they could acquire the remaining outstanding shares of their own subsidiaries. By using a "Maryland" subsidiary for this purpose, certain federal tax benefits were available that may not have been available without using a "Maryland" subsidiary as an intermediary.

² Unless otherwise noted, all statutory references are to 35 ILCS 5/101, *et seq.*, the Illinois Income Tax Act ("ACT").

"Rarified Chemical" argues that "Rarified Maryland's" interest income is not includable in the numerator of the sales factor because the income producing activity did not take place in Illinois. "Rarified Chemical" asserts that "Rarified Maryland" conducted its limited business activities exclusively in "Maryland". In support of that assertion, "Rarified Chemical" relies on a number of stipulated facts: "Rarified Maryland's" bank account was at the "Somewhere" Trust in "Maryland". The interest on the loans to the foreign subsidiaries was deposited in "Rarified Maryland's" account at the "Somewhere" Trust in "Maryland". "Rarified Maryland" had no property or paid employees in Illinois. Its only office was at the location of "ARU" in "Maryland". "Rarified Maryland" paid rent of \$450 to "ARU" under a shared office space arrangement with "ARU" in "Somewhere" during the months of October, November and December of 1991. "Rarified Maryland" employed "Edward Everett Horton", the president of "ARU", as an employee during 1991 and paid him salary of \$900 for that year. "Edward Everett Horton" was "Rarified Maryland's" only paid employee. He was responsible for payment of bills, preparation of his Form W-2 and "Rarified Maryland's" "Maryland" franchise, information, and quarterly payroll tax returns, and reviewing and reconciling "Rarified Maryland's" bank account.

"Rarified Chemical" argues that these factors show that all of "Rarified Maryland's" income producing activities were in "Maryland", and that under the "income producing activity" test set forth in Section 304(a)(3)(C), "Rarified Maryland's" interest income cannot be included in the numerator of "Rarified Chemical's" sales factor. The "income producing activity" test is set forth in section 304 which defines the sales factor.

The statutory language that defines the sales factor provides as follows:

The sales factor is a fraction, the numerator of which is the total sales of the person in this State during the taxable year, and the denominator of which is the total sales of the person everywhere during the taxable year. 35 ILCS 5/304(a)(3)(A).

The term “sales” is defined as “all gross receipts of the taxpayer not allocated under sections 301, 302 and 303.” 35 ILCS 5/1501(a)(21). The interest involved in this case is not allocated under sections 301, 302, or 303, so it comes within the statutory definition of “sales”.

The statute sites “sales” other than sales of tangible personal in Illinois with the following language:

Sales, other than sales of tangible personal property, are in this State if:

- (i) The **income-producing activity** is performed in this State; or
- (ii) The income-producing activity is performed both within and without this State and a greater proportion of the income-producing activity is performed within this State than without this State, **based on performance costs**. 35 ILCS 5/304(a)(3)(C). [emphasis added].

The Department’s regulation addressing the “income producing activity test”, in relevant part, provides:

The term "income producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the person in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a person, such as those conducted on its behalf by an independent contractor. The mere holding of intangible personal property is not, of itself, an income producing activity. Accordingly, the income producing activity includes but is not limited to the following:

- i) The rendering of personal services by employees or the utilization of tangible and intangible property by the person in performing a service. . . .
86 Admin. Code ch. I, § 100.3370(c)(3)(A).

The term “costs of performance” is defined, in relevant part, as follows:

The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the person. 86 Admin. Code ch. I, § 100.3370(c)(3)(B).

The Department's regulations further specify what activities are taken into account for the cost of performance test. The income producing activity does not include transactions and activities performed on behalf of a person, such as those conducted on the person's behalf by an independent contractor. 86 Admin. Code ch. I, § 100.3370(c)(3)(A). Also, the mere holding of intangible personal property is not, of itself, an income producing activity. *Id.* Thus, in this case, the activities performed by "ARU" must be disregarded because it is an independent contractor. The activities performed by the "Somewhere" Trust Company also must be disregarded because, not only was it an independent contractor, but its activities consisted of acting as custodian. The only individuals left are those located in "Someplace" that were officers of "Rarified Chemical" and "Rarified Maryland". They were the people whose activities, in creating and supervising the loan program, resulted in the interest income being earned by "Rarified Maryland", and the activities took place in Illinois. Therefore, under the cost of performance test, the interest income on the promissory notes was earned in Illinois and is properly included in the combined Illinois sales factor numerator for the tax year 1991.

The Department's *prima facie* case is established by the introduction into evidence of copies of its records under the certificate of the Director. 35 ILCS 5/914, Balla v. Dept. of Revenue, 96 Ill. App.3d 293 (1st Dist. 1981). In this case the Department's *prima facie* case was established when the parties stipulated to the Notice of Deficiency and the stipulation was entered into the record. A taxpayer's testimony alone will not overcome the Department's *prima facie* case. Central Furniture Mart v. Johnson, 157 Ill. App. 3d 907 (1st Dist. 1987). To overcome the Department's *prima facie* case the taxpayer must present consistent and probable evidence identified with its books and records. *Id.* "Rarified Chemical" has failed to introduce evidence sufficient to overcome

the Department's *prima facie* case which includes the interest income from the promissory notes in the numerator of "Rarified Chemical's" combined sales tax factor.

"Rarified Chemical's" argument that all of "Rarified Maryland's" income producing activities occurred in "Maryland" misstates the facts. The activities in "Maryland" cited by "Rarified Chemical" in support of its arguments are administrative functions. No activity, direct or indirect, was conducted in "Maryland" that, directly or indirectly, produced the interest income on the promissory notes.

The record does not show how much time or effort Mr. "Horton", the only "Rarified" employee located in "Maryland", devoted to "Rarified Maryland" matters as an employee of "Rarified Maryland". The record only shows what his responsibilities were, and the amount of salary paid to him in 1991 (\$900). That amount of salary suggests that his activities with respect to "Rarified Maryland" matters were minimal. Furthermore, there is no evidence showing that any of his activities contributed to the production of the interest income received by "Rarified Maryland" on the promissory notes. In fact, the record indicates that Mr. "Horton" had no responsibility with respect to the promissory notes. Therefore, his salary cannot be considered as part of the cost of performance.

The stipulated facts show that the activities conducted in "Someplace", Illinois by the "Rarified Maryland" officers, who are based there, were far more than stewardship activities as argued by the taxpayer. Substantially all of the activities that produced the interest income were conducted in Illinois. The only meeting of the "Rarified Maryland" board of directors in 1991 was held in "Someplace", Illinois. The minutes of the meeting were prepared in "Someplace". All of "Rarified Maryland's" officers were located in "Rarified Chemical's" offices in "Someplace", with the exception of an assistant secretary who was an officer of "Somewhere" Trust Company in

"Somewhere", "Maryland". The "Rarified Maryland" officers located in "Someplace" were also officers of "Rarified Chemical", with the exception of an assistant treasurer and the assistant secretary located in "Somewhere", "Maryland". The two "Rarified Maryland" officers who exercised control over all cash management decisions for "Rarified Maryland" were located in "Someplace".

The promissory notes between "Rarified Maryland" and the foreign subsidiaries were drafted in "Someplace" by personnel in "Rarified Chemical's" legal department. The promissory notes were signed by "Rarified Maryland" officers in Illinois. The currency fluctuation protection agreements for "Rarified Maryland" were authorized in "Someplace". "Rarified Maryland" officers located in "Someplace" were the authorized signatories on "Rarified Maryland's" accounts with "Fictional" Trust Company of New York. From their offices in "Someplace", two "Rarified Maryland" officers were in contact with the foreign subsidiaries regarding the promissory notes, their cash flow requirements and related matters. These activities, all of which were conducted in "Someplace", were the activities that produced the interest income in question.

"Rarified Chemical" argues that the Department failed to measure and reallocate the costs incurred in "Someplace" to produce the interest income, so under the cost of performance test, only the expenses actually incurred in "Maryland" should be used to determine where the interest income was earned, and, on that basis, the interest income cannot be included in the sales factor. This argument ignores the fact, as noted above, that once the Department's *prima facie* case is established, the burden of proof shifted to "Rarified Chemical" to overcome the Department's *prima facie* case. Balla, *supra*. To overcome the Department's *prima facie* case "Rarified Chemical" had to present consistent and probable evidence identified with its books and records. *Id.* "Rarified Chemical" did not introduce any evidence showing the amount of costs, if any,

incurred in "Maryland" that were directly connected with the production of the interest income "Rarified Maryland" received on the promissory notes. Thus, the record shows no costs of performance incurred in "Maryland" to compare to the costs incurred in "Someplace". Therefore, "Rarified Chemical" has failed in meeting its burden of proof.

"Rarified Chemical" relies on Dover Corporation v. Dept. of Revenue, 271 Ill.App.3d 700 (1st Dist. 1995) for concluding that the expenses incurred in Illinois to produce the interest income cannot be attributed to "Rarified Maryland". Dover involved the throwback rule set forth in Section 304(a)(3)(B)(ii) which requires that sales of tangible personal property shipped from Illinois to another state be attributed to Illinois, and included in the numerator of the taxpayer's sales factor, if the taxpayer is not taxable in the state of the purchaser. If the taxpayer is taxable in the state of the purchaser, the sales are attributable to that state. In Dover, The Appellate Court held that the term "taxpayer", for the purpose of the throwback rule, means each member of the unitary group, not the unitary group as a whole. 271 Ill.App.3d at 710.

"Rarified Chemical's" reliance on Dover is misplaced because this case does not involve the sale of tangible personal property, so it is factually distinguishable from this case, and there is no issue in this case regarding the meaning of the term "taxpayer". The issue in this case involves determining the performance costs incurred to produce the interest income on the promissory notes, and the state in which most of them were incurred. The application of the throwback rule is not involved in this case.

"Rarified Chemical" argues that the activities it conducted in earning the interest in question must be disregarded for purposes of sourcing "Rarified Maryland's" interest income because the Department did not quantify and reallocate to "Rarified Maryland" any costs incurred by "Rarified

Chemical" as it might have under Section 404.³ The fact that the Department did not make an allocation under Section 404 and that "Rarified Chemical" did not make a bookkeeping entry charging "Rarified Maryland" with these costs does not change the fact that costs of putting the loan program together and implementing it were incurred by the "Rarified Maryland" officers and their subordinates in "Someplace", Illinois. It is not reasonable to believe that that the legislature enacted a statutory provision that would permit a corporate parent and its subsidiary to site gross receipts for factor determination in or out of the state merely by making or not making a bookkeeping entry to transfer or not transfer costs incurred in generating portfolio income. As noted above, the burden of proving that the income producing activity occurred in "Maryland" is on the taxpayer, and the taxpayer, "Rarified Chemical", has failed to carry that burden. Therefore, the interest income on the promissory notes is properly includable in the numerator of the combined sales factor of "Rarified Chemical".

The Section 1005 Penalty Issue

The Department proposed a penalty under Section 1005 for underpayment of tax required to be shown on "Rarified Chemical's" return. Effective January 1, 1994, Section 1005 was amended so that the late payment penalty is now imposed under Section 3-3 of the Uniform Penalty and Interest Act. ("UPIA") 35 ILCS 735/3-1 *et seq.* Both sections provide for abatement of the penalty if the underpayment is due to reasonable cause. However, neither Section 1005 nor UPIA Section 3-8, which provide for abatement, define reasonable cause.

The regulations provide that reasonable cause is to be determined on a case by case basis taking into account all pertinent facts and circumstances. 86 Admin. Code ch., I, § 700.400 at ¶ (b). The most important factor is whether the taxpayer made a good faith effort to comply with the law

³ Section 404 allows the Director to allocate between related taxpayers items of income, deduction and any factor to properly determine the base income allocable to Illinois.

and if he exercised ordinary business care and prudence in doing so. *Id.* at ¶ (c) (e)(6). The regulations contain examples of situations demonstrating reasonable cause, but none of them are of help in this case.

There is little Illinois case law on what constitutes reasonable cause. However, there are federal income and estate tax cases involving the same issue that are informative, so reference to them is appropriate. The existence of reasonable cause justifying abatement of a penalty is a factual determination that must be decided on a case by case basis. Kroger v. Dept. of Revenue, 284 Ill. App. 3d 473, citing Rohrbaugh v. U.S., 611 F.2d 211,215 (7th Cir. 1979). Reasonable cause is shown where a deficiency results from an incorrect interpretation of the law and there is no showing of negligence or intentional disregard of the rules or regulations. Ireland v. Commissioner, 89 T.C. 978 (1987). Reasonable cause generally has been interpreted to mean the exercise of ordinary business care. Kroger, supra. Reasonable cause exists where the taxpayer has made an honest attempt to comply with the law. Du Mont Ventilation Company v. Department of Revenue, 99 Ill.App. 3d 263 (3rd Dist. 1981). Taxpayers can arrange their business so that their taxes will be held to a minimum; they are not bound to choose a pattern which maximizes their tax liabilities. Helvering v. Gregory, 69 F.2d 809 (CCA 2, 1934).

In this case, "Rarified Chemical" formed "Rarified Maryland" to obtain federal income tax benefits that could not be realized otherwise, a legitimate purpose. Although the definition of "sales" in the numerator of the sales factor provided in the statute and regulation are fairly precise in the case of sales of tangible personal property, neither the statute, the regulations nor case law address the specific issue raised in this case. In this case, there is no evidence of record showing intentional disregard of the statute, the regulations or of any case law precedent. The record indicates that "Rarified Chemical" has demonstrated the exercise of ordinary care and business

prudence. I find that "Rarified Chemical" demonstrated ordinary care and business prudence. Therefore, there is reasonable cause to abate the penalty assessed under Section 1005.

For the above reasons, I recommend that the tax assessment element of the Notice of Deficiency be recalculated as follows:

1. To take into account the order entered on November 27, 1997, excluding foreign dividends from the numerator and the denominator of the combined sales factor;

2. To include the interest income at issue in the numerator of the combined sales factor;
3. To abate the Section 1005 penalty.

Date: 8/1/99

Charles E. McClellan
Administrative Law Judge